Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
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IN THE
Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Respondents.

JUL 8 2001

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF ON THE MERITS OF SPRINT CORPORATION IN OPPOSITION TO PETITIONERS VERIZON COMMUNICATIONS, INC., *ET AL.*

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QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

RULE 29.6 STATEMENT

In accordance with Rule 29.6 of the Rules of this Court, Sprint Corporation ("Sprint") states as follows:

> Sprint is a corporation organized for the purpose of engaging in telecommunications and related businesses and is publicly traded under the names Sprint FON and Sprint PCS. Sprint Communications Company L.P. is a wholly-owned subsidiary of Sprint.

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PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.2 and 25.1, Sprint Corporation ("Sprint") respectfully submits this Respondent's Brief on the Merits in Opposition to Petitioners Verizon Communications, Inc., *et al.* addressing the following question:

> Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 ("Act") requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

Supreme Court Order List (Jan. 22, 2001) at 4.

STATEMENT OF THE CASE

A. Background

Unlike many of the private parties in these proceedings, Sprint has substantial local *and* long distance operations. Sprint has participated both as a new entrant and as an incumbent local exchange carrier ("ILEC") in state-regulated arbitrations pursuant to Section 252 of the Act. These experiences have given Sprint a balanced perspective on the challenges of opening local telephone markets to competition while satisfying the divergent interests of new entrants and ILECs. The "long distance side" of Sprint, like other new entrants, is interested in obtaining access to unbundled network elements ("network elements" or "UNEs") of ILECs at rates and on terms that permit meaningful local competition. The "local side" of Sprint, like other ILECs, is interested in ensuring that it receives just and reasonable compensation for providing UNEs to new entrants.

Sprint believes that the UNE pricing methodology adopted by the Federal Communications Commission ("FCC") strikes the proper balance in implementing the Act's pro-competitive objectives. The FCC established a forward-looking, long-run

methodology for pricing UNEs based on "the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." JA 51.[1] This methodology, which is known generally as "Total Element Long Run Incremental Cost" or "TELRIC," attempts to replicate prices that would prevail in a competitive environment, while ensuring that the ILEC is justly compensated for the use of its network elements at prices reflecting what it would cost to replace the functionalities provided by those elements today.

B. The Act

The Act seeks to transform state-sanctioned local monopolies into fully competitive markets on a national scale. *See* S. Conf. Rep. No. 104-230, at 113 (1996) (the primary goal of the Act is to increase competition in both local and long distance telephone markets as swiftly as possible). Congress recognized the practical and economic impediments that new entrants would face if forced to replicate all of the ILEC's existing local network infrastructure. Congress thus established comprehensive requirements "intended to facilitate market entry." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999) ("*IUB I*"). "Foremost" among them is the ILEC's "obligation under [the Act] to share its network with competitors." *Id.*

Section 251(c) provides three complementary avenues for new entrants to obtain access to an ILEC's network. First, a new entrant may "interconnect" its facilities with an ILEC's existing local network. JA 12-13. This enables the new entrant to transmit and receive calls to and from all local telephone subscribers without replicating an entire telephone network.

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[1] The Court has agreed to the submission of a deferred Joint Appendix ("JA").

Second, a new entrant may purchase an ILEC's retail services at wholesale rates and then resell the services to local customers under the new entrant's brand name. JA 13. This enables the new entrant to compete on the basis of price and service, without investing in any of its own facilities.

Third, and most relevant here, a new entrant may lease UNEs from the ILEC. *Id.* New entrants may use the leased UNEs, alone or in combination with the new entrant's own network facilities, to offer new and different competitive services. ILECs are to receive "just [and] reasonable" compensation for leasing UNEs, "based on the cost . . . of providing" the element, including a "reasonable profit." JA 13, 23.

Contrary to the ILECs' assertions, the Act expresses no preference for "facilities-based competition" among these three alternatives. This Court—and the Eighth Circuit—have already rejected that notion. In upholding the FCC's so-called "all elements" rule, which allows competitors to provide local telephone service relying solely on leased UNEs, this Court held that:

> [T]he [FCC] reasonably omitted a facilities-ownership requirement. The 1996 Act imposes no such limitation; if anything, it suggests the opposite, by requiring in § 251(c)(3) that incumbents provide access to "any" requesting carrier. We agree with the [Eighth Circuit] that the [FCC's] refusal to impose a facilities-ownership requirement was proper.

IUB I, 525 U.S. at 392-93. The Eighth Circuit similarly held that:

> [A]fter study, we do not believe that the Act's exclusive goal is facilities-based competition. While Congress may have envisioned facilities-based competition in local telephone markets to occur down the road, Congress clearly included measures in the Act, such as the interconnection, unbundled access, and resale provisions, in order to expedite the introduction of

> pervasive competition into the local telecommunications industry. Congress recognized that the amount of time and capital investment involved in the construction of a complete local stand-beside telecommunications network are substantial barriers to entry, and thus required incumbent LECs to allow competing carriers to use their networks in order to hasten the influence of competitive forces in the local telephone business.

Iowa Utils. Bd. v. FCC, 120 F.3d 753, 816 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). *Cf.* JA 271-272 (¶ 12) ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.").[2]

C. The FCC's *Local Competition Order*

Congress expressly authorized the FCC to promulgate rules implementing the Act's pro-competitive requirements and set few limits on the agency's exercise of that authority. JA 10, 14. As this Court has recognized, the key provisions of the Act are subject to multiple interpretations and Congress was "well aware" that these ambiguities would be resolved by the FCC. *IUB I*, 525 U.S. at 397.[3]

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[2] The ILECs' contention that Congress valued facilities-based competition over UNE-based competition is also disingenuous. For example, SBC, BellSouth, and Ameritech successfully argued to the FCC that UNE-based competition is the equivalent of facilities-based competition for purposes of meeting the requirements of Section 271(c)(1)(A) ("Presence of a Facilities-Based Competitor") of the Act, which prohibits Bell Operating Companies from offering long distance services in the areas in which they are the incumbent until they have proven that those local markets are effectively open to competition. *Application of Ameritech Mich. Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Servs. in Mich.*, 12 F.C.C.R. 20,543, 20,590-91 (¶¶ 86-87) (1997).

[3] The ILECs use statements from former FCC Chairman Reed Hundt to assert that the FCC "was dissatisfied with the 1996 Act" and purposely

Virtually the entire telecommunications industry participated in the FCC's rulemaking proceedings, which culminated in the *Local Competition Order*. A significant part of these efforts focused on the appropriate compensation that new entrants should pay to lease UNEs from ILECs. Most ILECs favored a pricing methodology that would allow recovery of the "historical costs" of their network elements. JA 359-361 (¶ 655). Most new entrants argued that a forward-looking methodology was necessary to allow competition to develop. JA 340-342 (¶ 635).

The FCC carefully evaluated the various cost methodologies proposed by the commenters, JA 325-423 (¶¶ 618-740), and ultimately determined that TELRIC was the most effective and fair means to implement the Act's pro-competitive goals, JA 379-380 (¶ 679). Based on substantial economic commentary and analysis, the FCC concluded that a forward-looking cost methodology, such as TELRIC, would best replicate the conditions of a competitive market. JA 379-380, 398-399 (¶¶ 679, 705). Typically, new firms enter a market and set prices based on the costs of building the most efficient facilities necessary to compete. Incumbents must then respond to those prices, even if their existing facilities are less efficient. JA 379-380 (¶ 679). Forward-looking pricing of UNEs helps to achieve a similar result. New entrants cannot immediately compete on equal terms because the costs of entry (*viz.*, replicating a ubiquitous local network)

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discriminated against the ILECs in favor of new entrants. These *post*-employment statements are irrelevant; they have also been misleadingly selected and quoted out of context. In the same passages cited by the ILECs, the former Chairman emphasized that the FCC "did not want to confer advantage on particular companies." Reed E. Hundt, *You Say You Want A Revolution* 155 (2000). He also noted that the Act produced "a mountain of ambiguity" and that subsequent regulations interpreting these ambiguities may allow new entrants a "fairer chance to compete," consistent with Congress' goal of opening the local telephone market to competition. *See id.* at 154.

are vastly too prohibitive to be incurred all at once. *Iowa Utils. Bd. v. FCC*, 120 F.3d at 816. A methodology based on forward-looking economic costs helps to "drive retail prices to their competitive levels" by setting costs at levels firms would face in a competitive market. JA 380 (¶ 679). This, in turn, "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." JA 333 (¶ 630).

The FCC also took steps to ensure that the TELRIC methodology allows ILECs to recover the full forward-looking cost of leased UNEs, by measuring the long-run, incremental cost of the network element based on: (i) the use of the "most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers," JA 51; (ii) the cost of capital, thus allowing ILECs to recover normal economic profit, *id.* and (iii) the useful life of the element, as measured by its economic depreciation rate, *id.* In addition, TELRIC allows for a reasonable share of joint and common costs. JA 51-52.

The FCC concluded that TELRIC would not always result in forward-looking costs that are below historical costs. Although the application of TELRIC to certain elements of an ILEC's local telephone network, such as switches and other computer-based components, may result in forward-looking costs below historical costs, the opposite may be true for other elements such as loops, whose costs are driven by material or labor. JA 398-399, 400-401 (¶¶ 705, 707). At the same time, the FCC determined that an ILEC's existing wire centers should be used as a component of TELRIC, precisely to "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, [would be] able to provide the service at a lower cost than the incumbent LEC." JA 384 (¶ 685).

The FCC considered and addressed each of the objections to TELRIC raised by the ILECs. By designing a forward-looking cost methodology that simulates a competitive market, the FCC sought to ensure that the rates eventually produced by TELRIC are properly balanced and enable new entrants to compete for local customers from the outset. JA 383-384 (¶ 685). On the one hand, if UNE rates are set below forward-looking costs, new entrants might be deterred from building competing facilities. Moreover, some new entrants might be induced to enter using network elements where it would not otherwise be economically efficient for them to do so. On the other hand, if UNE rates are set too high, which a methodology based on historical or "embedded" costs might produce, competitive entry may never occur. Because the costs of immediately building a completely ubiquitous local network would be prohibitive for any one firm, most new entrants must rely in part on leased UNEs to provide a full range of local services. Excessive UNE rates would make it impossible for new entrants to price these services at competitive levels, effectively impeding market entry.[4]

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[4] The ILECs claim that TELRIC pricing has caused "many entrants" to alter plans "away from deploying competing facilities." Brief for Petitioners ("Pet'r Br.") at 13, 49. This claim is rebutted by FCC data indicating that no single method of competitive entry predominates. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000* (May 2001). The isolated examples they cite to from 1996 fail to demonstrate that TELRIC caused "many new entrants" to halt facilities-based entry. At that time, the FCC's pricing rules were vacated and the individual state commissions were in the process of determining UNE pricing in individual arbitrations. Moreover, a myriad of reasons may explain why a particular company would modify a business strategy away from expending the massive amounts of capital needed for facilities-based entry. For example, a particular new entrant may have difficulty in raising the needed capital. *See* Letter from Chairman Michael Powell to Congress of 5/4/01, at 1. A new entrant may also reasonably wait to invest in facilities until it has reached sufficient

The FCC similarly rejected the ILECs' argument that forward-looking costs should be based exclusively on an ILEC's existing network, without regard to available, more efficient substitutes. JA 383 (¶ 684). Because this approach would allow ILECs to recover costs "that reflect inefficient or obsolete network design and technology," the FCC found it would be "essentially an embedded cost methodology." *Id.* A forward-looking methodology, in contrast, rationally examines what it would cost to replace the functions that make a network asset valuable. This includes currently available substitutes that perform the same functions as the original network element, but embody more efficient technologies to do so. JA 382-384 (¶¶ 683-685).[5]

The FCC also found that a forward-looking cost methodology would not result in a "taking" of the ILECs' property without just compensation. Under this Court's precedents, the "just and reasonable" standard of the Takings Clause requires, in the regulatory context, an examination of the "total effect" of the actual rates established by the agency. JA 419-421 (¶¶ 734-737). After reviewing the record, the FCC found that "[n]o incumbent LEC has provided persuasive evidence that prices based on a forward-looking

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scale by servicing customers through resale and UNEs, which in many parts of the country new entrants have failed to reach even today, five years after the Act's passage.

[5] The ILECs claim that TELRIC "hypothesizes a fantasy world in which carriers would repeatedly rip out and instantaneously rebuild their entire plant every time a newer technology hits the market or a more efficient configuration could be achieved." Pet'r Br. at 9-10. This assertion is exaggerated. TELRIC rationally measures the cost of providing the actual network element by asking what cost the ILEC or any other carrier would bear in the marketplace, *at the time the UNE rates are established*, to replace the functions of the network element at issue with currently available efficient substitutes consistent with the ILEC's existing wire center. UNE rates are typically in place for the term of an interconnection agreement, which is commonly three to four years, and are not changed "every time a newer technology hits the market."

economic cost methodology would have a significant impact on its 'financial integrity.'" JA 422 (¶ 738). Even so, the FCC specifically ordered the ILECs to "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Id.* (¶ 739). The FCC also determined that TELRIC is consistent with the "just and reasonable" standard used for takings that result in a physical occupation of property. JA 422-423 (¶ 740).

Finally, the FCC determined that state commissions would be able to implement TELRIC in setting UNE rates. A number of state commissions were already using forward-looking methodologies similar to TELRIC in setting retail rates for local services. JA 334-336, 381 (¶¶ 631, 681). As the FCC found, "the record demonstrates that such approaches are practical and implementable." JA 381 (¶ 681).

D. Judicial Review of the *Local Competition Order*

1. The First Eighth Circuit Decision

Challenges to the *Local Competition Order* were consolidated in the Eighth Circuit and first decided in 1997. Among other things, the Eighth Circuit invalidated the FCC's pricing rules—including TELRIC—holding that the Act gives state public utility commissions, not the FCC, general jurisdiction to interpret and implement the Act's pricing provisions. *Iowa Utils. Bd. v. FCC*, 120 F.3d at 794.

2. *IUB I*

On review, this Court held, *inter alia*, that Section 201(b) of the Act gives the FCC jurisdiction to adopt rules to implement all of the Act's local competition provisions. *IUB I*, 525 U.S. at 377-86. The Court reversed the Eighth Circuit's ruling that the FCC lacked the statutory authority to establish national pricing rules, reinstated the FCC's pricing rules, and remanded so that the Eighth Circuit could review the substantive challenges to them. *Id.* at 377-78.

3. The Eighth Circuit's Decision On Remand ("*IUB II*")

The Eighth Circuit found that the term "cost" in § 252(d)(1) is "ambiguous" and that the FCC was authorized to interpret the term to allow for a forward-looking cost methodology like TELRIC. *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 751-52 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 11a). The Eighth Circuit further held that the FCC's "use of a forward-looking cost methodology was reasonable . . . [and] that the FCC explained in detail its reason for selecting [such] a methodology to implement the new competitive goals of the Act." *Id.* at 752 (FCC Pet. App. 12a).[6]

The Eighth Circuit also rejected the ILECs' argument that the doctrine of constitutional avoidance required the FCC to use a historical cost methodology. "[A] takings claim," the court correctly noted, "cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *Id.* at 754 (FCC Pet. App. 17a). Accordingly, the Eighth Circuit held that:

> "It is not enough that a party merely speculates that a government action will cause harm." We do not need to disregard *Chevron* deference and interpret the statute in accordance with the petitioners' views in order to avoid an unconstitutional taking in this instance. The possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction. In such circumstances, the adoption of a narrowing construction might frustrate a potentially permissible application of a statute. Because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the resulting rates

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[6] The Eighth Circuit's vacation of Rule 505(b)(1) is addressed in Sprint's previously-filed Brief on the Merits in Support of Petitioners Federal Communications Commission and United States of America.

> have been determined and applied, the constitutional claim is not ripe.

Id. at 754 (citations omitted) (FCC Pet. App. 17a-18a).

SUMMARY OF ARGUMENT

The FCC's choice of the TELRIC methodology is entitled to substantial deference. Under *Chevron*, the agency's decision should be upheld unless "Congress has . . . addressed the precise question at issue" and unambiguously foreclosed the agency's choice or the agency's reasoning was arbitrary. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43, 845 (1984) ("*Chevron*"). The Act, as this Court found, "is in many important respects a model of ambiguity or indeed even self-contradiction" that imposes few restraints on the FCC's exercise of its implementing authority. *See IUB I*, 525 U.S. at 397 (the Act grants "most promiscuous rights" to the FCC). In applying *Chevron* deference to FCC regulations promulgated under the Act, this Court has held that such regulations should be affirmed unless they exceed the few "clear limits" that the Act contains. *Id.*

The Act does not mandate or prohibit any particular pricing methodology for UNEs. As the Eighth Circuit correctly found, "the term 'cost,' as it is used in [Section 252(d)(1)], is ambiguous and . . . Congress has not spoken directly on the meaning of the word in this context." *IUB II*, 219 F.3d at 751 (FCC Pet. App. 11a). The responsibility for interpreting and implementing that provision thus belongs to the FCC, not the courts. *Id.* at 752 (FCC Pet. App. 12a). The FCC evaluated numerous alternatives, including historical and forward-looking cost methodologies, before determining that TELRIC would best serve the dual goals of fairly compensating ILECs for UNEs while promoting the competitive market conditions desired by Congress. JA 325-423 (¶¶ 618-740). The FCC also "explained in detail its reason for selecting a

forward-looking cost methodology to implement the new competitive goals of the Act." *IUB II*, 219 F.3d at 752 (FCC Pet. App. 12a). The agency's expert judgment to use TELRIC, rather than a methodology that includes historical costs, was well-reasoned, supported by the record, and should be affirmed.

The ILECs assert that TELRIC is an "unmanageable" methodology and that it was arbitrary and capricious for the FCC to adopt it. This claim is readily disproved. In adopting TELRIC, the FCC found that the methodology was both practical and implementable by the states. These findings have been confirmed by experience, as state commissions around the country have successfully applied TELRIC in establishing UNE rates within the timetables set by the Act. Even after the Eighth Circuit invalidated the FCC's promulgation of TELRIC on jurisdictional grounds, a majority of state commissions adopted the methodology, independently concluding that it best served the goals of fairly compensating ILECs, promoting local competition, and ensuring efficient entry, utilization, and expansion of the telecommunications infrastructure.

The FCC's adoption of the TELRIC methodology does not violate the Fifth Amendment to the United States Constitution. The ILECs wrongly claim that the FCC "shifted" methodologies from a historical to a forward-looking cost methodology and that this "opportunistic switch" results in an uncompensated taking. This argument is based on an analytical artifice that lacks factual and legal foundation. Congress charged the FCC with implementing an entirely new regulatory regime that opens decades-held monopolies to competition. The FCC was not bound by any of the historical and forward-looking cost methodologies used by the agency or the states in establishing rates during the monopoly era. Rather, the FCC was obligated to use its expert judgment in adopting a methodology that both comports with the Act's UNE pricing standards and promotes

the pro-competitive goals of Congress. The FCC's adoption of TELRIC helps to implement the new Act and in no way resembles the type of "opportunistic switch" from a settled cost methodology that might raise constitutional concerns under this Court's precedents.

The ILECs' "takings" challenge to the TELRIC methodology itself also fails. A takings claim must be based on an actual rate, not the ratemaking methodology. "It is not theory but the impact of the rate order which counts." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope Natural Gas*"). As the Eighth Circuit found, the ILECs' takings claim remains purely theoretical. The ILECs presented no credible evidence during the FCC rulemaking that TELRIC prices or the Act's overall pricing scheme would significantly affect their financial integrity. Nor have they provided any persuasive evidence of such effects here. Even if a takings challenge to the TELRIC methodology were ripe, it would still fail. The TELRIC methodology allows ILECs to recover their full forward-looking costs of providing UNEs to new entrants. When properly applied, the methodology comports with the Act's requirement that ILECs receive "just and reasonable" compensation for leasing UNEs. The ILECs are entitled to no more.

Finally, the ILECs wrongly argue that the "constitutional avoidance" doctrine negates *Chevron* deference and requires adoption of a historical cost methodology. Mere allegations that a regulatory program may result in a taking does not justify the use of a narrowing construction which might frustrate a potentially permissible application of a statute. *See United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-29 (1985) ("*Riverside Bayview Homes*"). The Act provides a mechanism for the ILECs to receive compensation through state-arbitrated UNE rates, thus obviating any basis for a limiting construction. The ILECs have not shown that

any actual rates derived from TELRIC are so unjust as to be confiscatory. Their unsubstantiated claims of potential constitutional infirmity provide no basis for this Court to disregard *Chevron* deference in favor of the ILECs' restrictive views of the Act's UNE pricing provisions.

ARGUMENT

I. NOTHING IN THE ACT REQUIRES INCORPORATION OF AN ILEC's HISTORICAL COSTS INTO THE RATES FOR UNEs.

Section 252(d)(1) of the Act requires "just and reasonable" rates for UNEs "based on the cost . . . of providing the . . . network element. . . . and may include a reasonable profit." JA 22-23. The Eighth Circuit properly determined that Section 252(d)(1) is ambiguous as to the cost methodology that may be employed in establishing UNE rates. *IUB II*, 219 F.3d at 751-53 (FCC Pet. App. 10a-14a). The Eighth Circuit thus upheld the FCC's adoption of a forward-looking cost methodology as a reasonable interpretation of the statute. *Id.* at 752-53 (FCC Pet. App. 11a-14a). The ILECs challenge these holdings, arguing that the "plain text, structure, and purpose of Section 252" demonstrate that Congress unambiguously intended for an ILEC's "historical" costs to be included in the UNE rate methodology. Brief for Petitioners ("Pet'r Br.") at 16, 19-21. These arguments are unpersuasive when measured against the statutory language and scheme.

A. Section 252(d)(1) Is Ambiguous And Does Not Require The Use Of Historical Costs In Establishing UNE Rates.

The ILECs' "plain text" argument relies heavily on various dictionary definitions of "cost" that have little relevance to the term's use in the ratemaking context. According to the ILECs, "cost" simply means the amount paid for an item at the time it was purchased or built. *Id.* at 19. They contend,

therefore, that the term "cost," as used in Section 252(d)(1)(A)(i), must include all of an ILEC's past expenditures, *i.e.*, "historical" costs. *Id.* The ILECs also rely on the purported use of the term "cost" in the *pre*-Act monopoly era, arguing that "for decades" the telecommunications industry has used the term "cost" to mean "historical" cost and that Congress intended for the term's use in Section 252(d)(1) to be vested with that same meaning. *Id.* at 20.

Contrary to the ILECs' assertions, the term "cost," when used in the regulatory ratemaking context, is susceptible to different meanings and is not confined to a particular dictionary definition. The Act neither defines the term "cost," as used in Section 252(d)(1), nor does it require that UNEs be priced based on any particular cost methodology. As the Eighth Circuit found, "Congress has *not* spoken directly on the meaning of the word in this context. . . . '[T]he word "cost" is a chameleon, capable of taking on different meanings, and shades of meaning, depending on the subject matter and the circumstances of each particular usage.'" *IUB II*, 219 F.3d at 751-52 (emphasis added) (quoting *Strickland v. Commissioner, Maine Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir. 1995)) ("the word 'cost' is a chameleon") (FCC Pet. App. 11a); *see Appalachian Power Co. v. EPA*, 135 F.3d 791, 809 (D.C. Cir. 1998) (noting "essential ambiguity of the word"). Such an ambiguous term confers, in the words of Justice Breyer, "'broad methodological leeway,'" and "say[s] little about the 'method employed' to determine a particular rate." *IUB I*, 525 U.S. at 423 (citation omitted). The FCC, therefore, properly exercised its authority in interpreting the term to permit a forward-looking cost methodology for establishing UNE rates. *See id.* at 397.[7]

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[7] Similarly, the Act's "just and reasonable" pricing provisions are the type of "ambiguous statutory terms" that require "substantial deference to the interpretation the [FCC] accords them." *Capital Network Sys., Inc. v.*

Moreover, Section 252(d)(1) refers to the "cost . . . of *providing*" the UNE to new entrants. This language supports the use of a forward-looking methodology by directing the inquiry to the costs resulting from a new entrant's use of the UNE today, and not what the UNE cost to the ILEC when originally purchased. Any rational firm, including an ILEC, would replace these elements with the most efficient available technologies. *See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 311-12 (1923) (Brandeis, J., concurring) (the proper inquiry "would be, not what it would cost to reproduce the identical property, but what it would cost to establish a plant which could render the service, or in other words, at what cost could an equally efficient substitute be then produced"); *see also Mobil Oil Exploration & Producing Southeast, Inc. v. United Distrib. Cos.*, 498 U.S. 211, 219 (1991). TELRIC properly sets prices based on the "replacement costs" that firms would currently incur to provide the same UNE functions. This approach properly compensates ILECs for the fair value of the assets they use in "providing" UNEs to new entrants, consistent with the language of Section 252(d)(1).[8]

FCC, 28 F.3d 201, 204 (D.C. Cir. 1994). Indeed, for more than half a century, the statutory mandate that rates be "just and reasonable" has been understood as granting an agency discretion to choose between a forward-looking and a historical-cost approach. *Hope Natural Gas Co.*, 320 U.S. at 602; *see* Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise* § 3.4 (3d ed. 1994) (agency setting "just and reasonable" rates has discretion in selecting rate methodology to comport with statutory policy decisions).

[8] The ILECs make a weak attempt to distinguish the term "cost" from the term "value." They argue that by compensating ILECs for the replacement cost that would be paid on the open market for the functions of the network element, TELRIC improperly measures "value" not "cost." This purported distinction is overstated. The terms "cost" and "value" are widely recognized as being synonymous. *Webster's New World Thesaurus* 156, 804 (new rev. ed. 1985). The ILECs also ignore the remainder of the statutory language, which requires examination of the

Section 252(d)(1) also expressly requires that UNE rates be established "*without reference* to a rate-of-return or other rate-based proceeding . . . ." JA 23 (emphasis added). Historical costs are invariably determined in a rate-of-return proceeding. *See Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1258-59 (D.C. Cir. 1993) ("*Illinois Bell II*"). This statutory language further suggests that Congress did not intend for, let alone mandate that, historical costs be included in UNE prices.

The ILECs also overstate the telecommunications industry's past usage of the term "cost" as requiring a historical cost methodology. Pet'r Br. at 19. Forward-looking cost methodologies have been part of this country's regulatory tradition for over fifty years, and there was a time when this Court believed that the Constitution *mandated* such an approach. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) ("*Duquesne*"). Several states were also implementing forward-looking methodologies to encourage local telephone competition before the Act. JA 334-336, 381 (¶¶ 631, 681). In all events, the FCC was under no obligation to use a particular cost methodology from the *pre*-Act era to implement the pricing provisions of Section 252(d)(1). The Act creates a new regime that fundamentally shifts the provision of local telecommunications services away from the past monopoly environment to a new competitive environment. Congress mandated that new entrants have access to UNEs to compete in the local telecommunications market. The Act did not require the FCC to apply remnants of the old monopoly system to the pricing methodology that it was

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"cost . . . of providing" the UNE. This language supports a methodology that looks to the current value of the assets used to provide the UNE functions, for the reasons shown.

jurisdictionally authorized to implement, and the FCC found no reasonable basis to do so.[9]

Finally, the ILECs argue that Congress "clearly" mandated the use of historical costs because Section 252(d)(1)(B) contains the terms "may include a reasonable profit." The ILECs claim that a "reasonable profit" cannot be realized unless all of an ILEC's historical costs are first recouped. This argument fails for several reasons.

Use of "[t]he word 'may' in a statute normally confers a discretionary power, not a mandatory power." *Apex Plumbing Supply, Inc. v. U.S. Supply Co.*, 142 F.3d 188, 192 (4th Cir. 1998) (citation omitted). Congress thus provided the FCC with discretion to incorporate a "reasonable profit" into the pricing methodology, but did not require the agency to do so.

As the Eighth Circuit also noted, "[a] 'profit' can be made whether a historical cost or forward-looking cost methodology is used." *IUB II*, 219 F.3d at 752 (FCC Pet. App. 13a). The FCC addressed this point during the rulemaking, explaining that "[t]he concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements." JA 393 (¶ 700); *see also Burlington N. R.R. v. Surface Transp. Bd.*, 114 F.3d 206, 210, 212-14 (D.C. Cir. 1997) (rates based on forward-looking costs of "hypothetical

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[9] The ILECs wrongly suggest that, because the FCC stated in the entirely different context of cable rate regulation that "'[o]riginal cost is the normal, now traditional method used for public utility rate valuation,'" the agency must use a historical cost methodology here. Pet'r Br. at 20 (citation omitted). In implementing the Cable Act, which is governed by a more traditional ratemaking scheme, the FCC was not attempting to choose the measure of cost best suited to opening a market to competition. The FCC is fully authorized to choose a regulatory tool best suited to one context and a different regulatory tool best suited to a different situation.

'stand-alone railroad'" provide "a competitive return on all investments the railroad actually made at their current value"). Thus, an ILEC can "obtain a 'reasonable profit' without recovering all of its embedded costs." *Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc.*, No. A 97-CA-132 SS, 1998 WL 657717, at *11 (W.D. Tex. Aug. 31, 1998) ("*SWBT*"); *see also GTE S., Inc. v. Morrison*, 6 F. Supp. 2d 517, 529 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999) ("*GTE South*").

Lastly, in a competitive environment, market forces drive rates to forward-looking costs. JA 379-380 (¶ 679). Profits in excess of forward-looking costs are not "normal." Edwin Mansfield, *Microeconomics* 252-53 (6th ed. 1988); *SWBT*, 1998 WL 657717, at *10; *see* JA 393-395 (¶ 700). By arguing that forward-looking costs do not provide them with a "reasonable profit," the ILECs essentially argue that they are entitled to more profit than is available in either a competitive or a regulated market. While the ILECs may prefer such a windfall, the Act does not *allow*, much less require, it. The FCC was not authorized to include anything more than a "normal" profit in its forward-looking cost methodology. Had the FCC granted ILECs a "supra-normal" profit, as they apparently urge, the agency would have violated the Act's mandate that rates be "reasonable." JA 393-394 (¶ 700 & n.1707).

B. Other Provisions Of The Act Do Not Compel The Use Of Historical Costs For UNE Pricing.

1. The Act Expresses No Preference For Historical Cost Models And There Is No Reason To Infer One.

Congress required the FCC to "complete all actions necessary to establish regulations to implement" the Act within six months. JA 14. From this "congressional desire for swift action," and Section 252(d)(1)'s proscription against

the use of "rate-of-return or other ratemaking proceeding[s]," the ILECs attempt to infer that Congress intended for the term "cost" to mean "already established and readily available" historical costs. Pet'r Br. at 22. This argument rests on the false premise that forward-looking cost models are "novel, complex, and difficult-to-administer," while historical cost models are easy to use and ready off-the-shelf. *Id.*

Modern economic modeling has made forward-looking cost methodologies, in the words of the FCC, both "practical and implementable." JA 381 (¶ 681); *see also American Public Gas Ass'n v. Federal Power Comm'n*, 567 F.2d 1016, 1036-37 (D.C. Cir. 1977) (forward-looking cost methodologies have been routinely used by regulatory agencies to establish rates). Numerous courts and agencies have specifically endorsed forward-looking cost methodologies where the regulatory goal is "to encourage competition." *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 411-12 & nn.12-13 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000) ("*GTE*"). Most experts within and outside the government also agree that a historical cost approach is no less difficult or complex to administer than a forward-looking model. JA 333-334, 340-342 (¶¶ 630, 635).

The notion that the FCC was incapable of evaluating anything but a historical cost methodology during the six-month rulemaking period established by the Act is far-fetched and readily disproved by the administrative record. The FCC evaluated several approaches—including historical and forward-looking cost methodologies—in promulgating implementing regulations for Section 252(d)(1). The *Local Competition Order* contained over 100 paragraphs addressing pricing methodologies and was issued within the six-month

statutory timeframe. JA 325-423 (¶¶ 618-740).[10] Moreover, the Act contemplated that these new rules, once issued, would be applied by the state commissions to establish actual UNE rates in individual arbitrations over at least another nine-month period. JA 21-22.

The ILECs' argument also wrongly presumes that state commissions would be incapable of applying anything other than historical cost models in setting UNE rates. This claim similarly is disproved by the record. State commissions have not found TELRIC "novel, complex, and difficult-to-administer." Pet'r Br. at 22. In the five years since the Act's passage, state commissions throughout the country have established UNE rates using TELRIC. *See, e.g., GTE South*, 6 F. Supp. 2d at 526-30; *SWBT*, 1998 WL 657717, at *16 (upholding Texas PUC's use of TELRIC and finding TELRIC "compelled" by the Act). Indeed, many state commissions independently decided to use TELRIC during the period when the FCC's pricing rules were invalidated by the Eighth Circuit on jurisdictional grounds.

Lastly, there is no reason to believe that a historical cost methodology would be easier to apply or would result in more accurate rates than other cost models, as the ILECs wrongly suggest. In 1990, the FCC moved away from traditional cost of service regulation based on historical costs and adopted a "new system" of price cap regulation. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990). Historical costs, therefore, were not "readily available" to the agency and would have had to be

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[10] The ILECs contend that due process requires "notice and a right to be heard" when a change in rate methodology affects a firm's recovery. Pet'r Br. at 22 n.13, 47. The ILECs received notice of and participated in the proceedings before the FCC, thereby satisfying any purported "due process" concerns. JA 328 (¶ 622) (describing Notice of Proposed Rulemaking requesting comments on the type of pricing methodology for network elements), JA 359-361 (¶ 655) (describing ILECs' argument for the use of historical costs).

developed essentially from scratch. The historical costs carried on an ILEC's books are not generally allocated to particular categories of network elements. The relevant inputs to historical cost models, therefore, cannot be calculated by simply adding up a series of historical cost figures. The need for economic modeling to determine and verify particular network element prices still exists with the use of historical costs. *GTE South*, 6 F. Supp. 2d at 527 (upholding Virginia commission's refusal to adopt GTE's historical cost model which was labeled a "black box" because its operation and assumptions could not be tested or effectively challenged by others). For these reasons, there is no basis to presume that use of historical costs would be any less difficult or complex to administer than a forward-looking cost model. *See National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993) ("rate of return regulation is costly to administer, as it requires the agency endlessly to calculate and allocate the firm's costs") ("*National Rural Telecom*"). To the contrary, the complexity and unwieldiness of rate-of-return proceedings has led many agencies to abandon historical cost pricing. Regulators have increasingly found forward-looking cost methodologies to be more reliable and practical than historical cost models. *See* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 9.2 (1st ed. 1992) ("In practice, rate of return regulation usually culminates in poor regulation of cost, with prices allowed to float upward."), *id.* § 9.8 ("We now know that by the early 1980s the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction.").

2. The Act's Resale Pricing Provision Does Not Implicitly Endorse Historical Or Forward-Looking Cost Models.

The ILECs also wrongly contend that the Act's resale pricing provision, 47 U.S.C. § 252(d)(3), demonstrates a

congressional intent to use historical costs to price network elements. Pet'r Br. at 22-23. Section 252(d)(3) requires ILECs to provide their retail services to new entrants at wholesale discounts for resale. The resale price is based on the ILEC's retail tariffs, regardless of how those retail tariffs are set in a particular state. In those states that establish retail tariffs based on forward-looking cost models, the wholesale discount price would reflect that cost methodology. JA 438-439 (¶ 915). Conversely, in those states that use historic cost methodologies, the wholesale discount price would reflect those models. *Id.* Section 252(d)(3) is thus agnostic as to the cost methodology used by a particular state. Neither Congress nor the FCC expressed any preference for setting wholesale rates based on historical costs.[11]

C. The FCC's Choice Of A Forward-Looking Cost Methodology Was Not Arbitrary Or Capricious And Is Entitled To Deference.

The Eighth Circuit correctly held that the FCC's use of a forward-looking cost methodology was reasonable and well-explained. *IUB II*, 219 F.3d at 752 (FCC Pet. App. 12a). The ILECs dispute the FCC's choice, arguing that: (1) historical costs would be a better measure than forward-looking costs; (2) forward-looking costs methodologies are "unmanageable"; and (3) the FCC failed adequately to explain its reasons for "abandoning" historic costs. Pet'r Br. at 44-49. These challenges, at bottom, relate to the wisdom of the FCC's policy decision that a forward-looking cost methodology would better serve Congress' goal of rapid competition than a historical cost model. Under *Chevron*, that policy decision was for the FCC to make. 467 U.S. at 865 ("When a challenge to an agency construction of a statutory provision,

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[11] The ILECs' reference to the Act's resale pricing standards is ironic, since they argue elsewhere that their retail rates are often established at prices "substantially *below* cost." *See* Pet'r Br. at 4 (emphasis added).

fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail.").

1. Historical Costs Are Antithetical To The Act's Objectives.

The FCC did not exclude historical cost models on a whim. The agency carefully considered the issue and concluded that pricing UNEs based on the historical or "embedded" costs carried on an ILEC's accounting books would be *antithetical* to the pro-competitive goals of the Act. The FCC recognized that these historical costs could be higher or lower than the costs derived from a forward-looking cost model. JA 398-399 (¶ 705). Even so, the FCC reasoned that the use of historical costs in determining the rates paid by new entrants would force competitors to pay for the existing inefficiency of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry contemplated by the . . . Act." JA 399 (¶ 705). Allowing ILECs to price UNEs based on historical costs would force new entrants to price their retail services based on those costs. Because ILECs control the only facilities currently available to provide widescale local service, they could then undercut the prices of any potential competitors. JA 441-442 (¶ 1065). An incumbent could "set its own rates based on the present value of providing the service"—that is, by writing off obsolete investments just as a competitive firm would—while forcing competitors to "pass along to [their] customers the inflated, monopoly-era historical costs [the ILEC] seeks to charge new entrants." *SWBT*, 1998 WL 657717, at *13. Forward-looking pricing for network elements, by contrast, places everyone "on a level playing field." *Id.*; *see also Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 18-19 (1st Cir. 1990) (Breyer, J.). As the FCC explained, "[t]he substantial weight of economic commentary in the record suggests that an 'embedded cost'-based pricing methodology would be

pro-competitor—in this case the incumbent LEC—rather than pro-competition." JA 398 (¶ 705). The FCC thus concluded that historical cost pricing would frustrate the Act's objectives. JA 398-399 (¶ 705).

The FCC also built sufficient flexibility into TELRIC to ensure that state commissions account for the effects of competition on ILECs. State commissions must consider these effects in setting the depreciation rates and cost of capital. JA 395-396 (¶ 702). The FCC found that:

> the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital or depreciation rate.

JA 395 (¶ 702). "States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted." JA 396 (¶ 702). Thus, contrary to the ILECs' claims, TELRIC allows state commissions to account for the effects of competition on investment incentives.

2. TELRIC Is Not "Unmanageable."

The ILECs' characterization of TELRIC as "unmanageable" is factually incorrect, Pet'r Br. at 45, for the reasons previously shown. The FCC made a reasoned determination that TELRIC would be "implementable" based on the proven experience of various state commissions. JA 334-336, 381 (¶¶ 631, 681). The practical experience of these state commissions was especially informative because, as the FCC recognized, state commissions would be the ones establishing UNE rates based on the FCC's methodology. JA 381 (¶ 681). Virtually every state commission has applied TELRIC in *post*-Act arbitrations, confirming the soundness of the FCC's

determination that TELRIC would be manageable to implement. Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 2.4.4.2 (2d ed. 1999).[12]

3. The FCC Did Not "Abandon" Historical Cost Models.

In a final attempt to portray the FCC's rulemaking as "arbitrary and capricious," the ILECs claim that the FCC failed adequately to explain its "decision to abandon historical costs in favor of TELRIC." Pet'r Br. at 46 This claim rests on a false premise. Prior to the Act, ILECs had no obligation to lease UNEs to competitors and the FCC was never called on to establish a cost methodology for UNE access. TELRIC is not an abrupt change from past practices. It is part of the FCC's implementation of an entirely *new* regime. Far from abandoning a settled methodology, the FCC was charged with promulgating a new one that provided just and reasonable compensation while promoting Congress' goal of rapid competition. The FCC fully explained its reasons for selecting a forward-looking cost methodology and

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[12] The ILECs utterly ignore the fact that TELRIC has been successfully implemented by the states and argue instead that TELRIC is an "unmanageable project" based on the FCC's experience in the universal service proceeding. Pet'r Br. at 45; *see also id.* at 12-13. That is not a valid comparison. The states' actual experience with TELRIC is the most relevant inquiry. The FCC's universal proceedings are vastly more complicated than a state commission arbitration to determine UNE prices for an individual ILEC. Congress created a wholesale change in the way universal service would be advanced nationally in the *post*-Act environment. JA 29-48. To implement these requirements, the FCC has conducted a complex, ongoing nationwide proceeding, which involves all state commissions, virtually all local and long distance carriers and other interested parties, and requires the FCC to work with and receive recommendations from a joint federal-state board. *Id.*; *see also* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 2.5 (2d ed. 1999) ("Perhaps the most daunting task assigned to the [FCC] by the 1996 Act was a thorough review and restructuring of the existing federal universal-service guarantees.").

for rejecting the use of historical costs. JA 325-423 (¶¶ 618-740). It was within the FCC's authority to make these determinations and its selection of TELRIC was not arbitrary or capricious.

II. THE FCC's SELECTION OF THE TELRIC METHODOLOGY DOES NOT VIOLATE THE TAKINGS CLAUSE.

The FCC's decision to exclude historical costs in the UNE rates that ILECs may charge new entrants does not violate the Takings Clause. Pet'r Br. at 24-26. The ILECs construct three arguments in an attempt to implicate constitutional takings principles. They first claim that the FCC's implementation of TELRIC was an "opportunistic switch" from a prior, well-settled historical cost methodology that provided for recovery of past prudent investment. *Id.* at 26-31. They next attack the TELRIC methodology itself, which they contend will force them to lease UNEs to new entrants at "a loss." *Id.* at 31-42. Finally, they argue that this Court must adopt a narrow construction of Section 252(d)(1)—which, in their view, would require the incorporation of historical costs—in order to avoid "serious constitutional questions" raised by TELRIC. *Id.* at 42-44. None of these claims has merit.

A. TELRIC Does Not Represent A Constitutionally Suspect Shift In Methodologies.

The ILECs wrongly argue that, in adopting TELRIC, the FCC "abandoned the longstanding regime under which incumbents were given the opportunity to recover their actual investment and moved to an extreme version of replacement costs." *Id.* at 26. "This fundamental shift," the ILECs contend, "necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime." *Id.*

The ILECs' attempt to cast TELRIC as a "fundamental switch" in cost methodologies is overstated. The Act does not purport to impose any cost methodology on the states in setting retail rates for an ILEC's traditional local services. Any purported "expectations" the ILECs may have based on the particular methodologies employed by the states for these services—whether they be based on historical or forward-looking costs—are unaffected by the Act. The Act's pricing standards instead apply to an entirely new regime that is designed to open local markets to rapid competition. ILECs had no prior obligation to provide UNEs to new entrants and there was no established methodology for pricing these elements. The TELRIC methodology was chosen by the FCC to implement the Act's pro-competitive requirements. The FCC was not bound by any particular methodology used to set rates in the *pre*-Act monopoly environment in determining how UNEs should be priced in the new competitive environment. Nor did the ILECs have any vested right to expect that they would be shielded from a methodology based on forward-looking rather than historical costs. As this Court explained decades ago:

> [w]hether competition between utilities shall be prohibited, regulated or forbidden is a matter of state policy. That policy is subject to alteration at the will of the legislature. The declaration of a specific policy creates no vested right to its maintenance in utilities then engaged in the business or thereafter embarking in it.

Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118, 141 (1939) ("*Tennessee Electric*").

The ILECs also wrongly attempt to use *Duquesne* as authority for the proposition that, whenever a regulatory agency adopts a new rate methodology, it must guarantee that the carriers recover "all their previous prudent investment and an appropriate rate of return under the old methodology." Pet'r Br. at 27. Thus, once regulators base rates on historical costs, the ILECs contend, it creates a promise that must be

honored under the Constitution. Any change in future rates must provide for recovery of those costs, regardless of the present value of the underlying network assets. *Id.*

Duquesne expressly refutes the ILECs' proposition that recovery of historical costs is constitutionally required. The Takings Clause prevents rates that are "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired." *Duquesne*, 488 U.S. at 307; *see also Market St. Ry. v. Railroad Comm'n of Cal.*, 324 U.S. 548, 567 (1945) (the Takings Clause prevents only "governmental destruction of *existing economic values*" and does not require compensation based on "the present reproduction value of something no one would presently want to reproduce" or the "historical valuation of a property") (emphasis added) ("*Market Street Railway*"). Indeed, prior to *Duquesne*, "it was thought that the Constitution *required*" compensation based on "present value." *Duquesne*, 488 U.S. at 308 (emphasis added). In *Duquesne*, this Court explained that the Constitution does not mandate a single theory of valuation, stating, in pertinent part, that:

> [C]ircumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves the [regulators] free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.

Id. at 316; *see also Hope Natural Gas*, 320 U.S. at 602 (The Takings Clause does not confine regulators "to the use of any single formula or combination of formulae in determining rates."). Under *Duquesne*, therefore, the FCC had broad authority to establish a cost methodology for UNE rates that, in the agency's expert view, "best meets" the objectives of the new Act, regardless of the cost methodologies used by the agency or the states in the *pre*-Act regime.

Even assuming, for argument's sake, that TELRIC represented a "shift" in methodologies, it would not raise a serious constitutional question. As shown, TELRIC provides just compensation to the ILECs by permitting full recovery of the current fair value of the UNEs. The Takings Clause requires no greater compensation, *see United States v. Miller*, 317 U.S. 369, 374 (1943), and the ILECs have no right to expect more. The ILECs acknowledge that the measure for evaluating an alleged property deprivation is the reasonable, investment-backed expectations of the property owner. Pet'r Br. at 29. This Court has repeatedly held that reasonable investors cannot expect an existing ratemaking scheme to be permanent or claim entitlement to particular regulatory treatment. *E.g.*, *Tennessee Electric*, 306 U.S. at 141; *see also American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry.*, 387 U.S. 397, 416 (1967). *Cf. New York Cent. R.R. v. White*, 243 U.S. 188, 198 (1917) ("No person has a vested interest in any rule of law, entitling him to insist that it shall remain unchanged for his benefit."). It is thus constitutionally permissible for a regulatory agency to establish new rates based on a changed methodology that excludes historical costs prudently invested. In *Duquesne*, for example, this Court upheld rates that reflected the "current market value" of the utility's investments, even though this approach denied recovery of tens of millions of dollars of prudently incurred historical expenditures. 488 U.S. at 312-14. Similarly, in *Hope Natural Gas*, the Court affirmed the adoption of a new approach for calculating the rate base, even though the resulting rates "might produce only a meager return" on the prior rate base. 320 U.S. at 605. In *Market Street Railway*, the regulatory commission based rates on the present value of a company's assets ($7.95 million), even though the "book value" of the property exceeded $41 million and its "historical reproduction costs" exceeded $25 million. 324 U.S. at 564-68. The Court held that the regulated entity was not constitutionally entitled to compensation based on

"the historical valuation of a property whose . . . current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made." *Id.* at 567; *see also In re Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968) (Courts will not "set aside [a rate order] merely because the [regulatory agency] has on an earlier occasion reached another result.") ("*In re Permian Basin*"). These authorities make clear that the ILECs and their investors had no reasonable basis to "count on" a historical cost methodology "as a necessary component for supplying a constitutional return under the old regime." Pet'r Br. at 30.

Duquesne also establishes that changes in regulatory treatment implicate the Takings Clause only under narrow circumstances; *viz.*, when the state "arbitrarily switch[es] back and forth between methodologies in a way which require[s] investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." 488 U.S. at 315. The FCC adopted TELRIC to implement the Act's new UNE access requirements. The agency has not arbitrarily switched "back and forth" between cost methodologies and nothing in the record remotely resembles such opportunistic rate manipulation. Moreover, as shown, the FCC had moved away from traditional cost of service regulation based on historical costs in favor of price cap regulation several years before the Act's passage. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990). Price cap regulation establishes rates by considering, among other things, "expected savings from innovation and other economies" that are necessarily "forward-looking." *National Rural Telecom*, 988 F.2d at 178. It is indeed ironic for the ILECs to claim that the FCC's so-called "switch" to TELRIC has a constitutional dimension here, given that they did not challenge the constitutionality of the FCC's "switch" from

traditional cost of service regulation to price cap regulation over a decade ago.

In addition to the legal flaws in the ILECs' analysis, their claim that the purported "switch" to TELRIC "wipe[s] out a significant portion of the recovery on past investments" lacks any credible factual basis. The ILECs assert that they have invested $342 billion in their networks over time, based on newly introduced data that they provided to the FCC in a separate, unrelated context. Pet'r Br. at 10-11. Apart from the questionable relevance of these data, they show that approximately $176 billion of that original investment has been *depreciated* on the ILECs' books—a point conveniently missing from the ILECs' analysis. *1999 Statistics of Communications Common Carriers*, table 2.9, at 51 (rel. Aug. 11, 2000). Even under a historical cost methodology, the ILECs' original investment is worth only $166 billion today based on their own data. *Cf. Illinois Bell II*, 988 F.2d at 1258-59 & n.5 ("Since depreciation is an operating cost, investors recover such amounts dollar for dollar.") (citing Breyer & Stewart, *Administrative Law and Regulatory Policy* 237 n.59 (2d ed. 1985)). In comparison, the ILECs contend that TELRIC values those same assets at $180 billion. Pet'r Br. at 10-11. The ILECs' argument that TELRIC "under-values" their networks and "strands" historical costs in a "harshly retroactive" way is thus wholly unsupported.

Although there is no evidence in the record regarding the extent of UNE leasing by new entrants, it is beyond dispute that ILECs continue to control more than 92% of the local markets. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000*, at Table 1 (May 2001). The ILECs, therefore, continue to recover the vast majority of their "historical" network costs through the retail rates established by the state commissions in traditional intrastate rate-of-return proceedings. It seems likely that most, if not all, of an ILEC's undepreciated historical costs existing in 1996 will have been recovered through its retail

rates long before any meaningful UNE-based competition takes hold.

B. The ILECs' Theoretical Attacks On TELRIC Are Barred By The Well-Settled "Total Effect" Test For Regulatory Takings.

This Court has held that "[i]t is not theory but the impact of the rate order which counts." *Hope Natural Gas*, 320 U.S. at 602. Accordingly, the Court has rejected theoretical challenges to rate methodologies and examined instead the "total effect" of actual rates for takings purposes. *Id.* An uncompensated taking results only if *application* of the ratemaking methodology produces overall rates so low as to "jeopardize the [regulated entity's] financial integrity . . . either by leaving [it with] insufficient operating capital or by impeding [its] ability to raise future capital." *Duquesne*, 488 U.S. at 312. This "total effect" test is necessary to ensure that regulators have sufficient methodological leeway to resolve the complicated economic judgments and difficult policy issues involved in setting rates. *Id.* at 314.

The ILECs make no credible attempt to satisfy the "total effect" test in challenging TELRIC. Rather, they contend that the FCC "misapplied" the test "by looking to revenues earned from *all* of an incumbent's operations" in order to "cure" the "below-cost" UNE rates resulting from TELRIC. Pet'r Br. at 32 (emphasis in original). Relying on *Brooks-Scanlon Co. v. Railroad Commission of Louisiana*, 251 U.S. 396, 399 (1920) ("*Brooks-Scanlon*"), the ILECs argue that the FCC may not set "below-cost" rates in one line of business and offset any such deficiency from revenues in a different, unregulated line of business. Pet'r Br. at 33-34.

These arguments mischaracterize the record. TELRIC does not result in "below-cost" rates. As previously shown, TELRIC allows for full recovery of an ILEC's costs plus a reasonable profit, based on a forward-looking methodology.

Nor did the FCC "'distort[]' the *Duquesne* 'total effect' test by claiming that it could look to *all* of an incumbent's overall revenues to make up for any deficiency in TELRIC rates," as the ILECs wrongly suggest. *Id.* at 32 (citing JA 421-422 (¶ 738)) (emphasis in original). The agency explained its analysis as follows:

> In adopting the rules that govern [UNE] rates, under *Hope Natural Gas* we must consider whether the end result of incumbent LEC rates is just and reasonable. Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed. . . . Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred. Thus, the mere fact that an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.
>
> Moreover, *Hope Natural Gas* requires only that the end result of our overall regulatory framework provides LECs a reasonable opportunity to recover a return on their investment. In other words, incumbent LECs' overall rates must be considered, *including the revenues for other services under our jurisdiction.*

JA 420-421 (¶¶ 736-737 & n.1756) (emphasis added). The record thus shows that the FCC properly analyzed the ILECs' theoretical "taking" claims to TELRIC under this Court's precedents. The FCC did not look to revenues from unregulated segments of the ILECs' businesses, as the ILECs claim, but rather expressly confined its analysis to whether the "end result of [the agency's] overall regulatory framework" provided for just compensation, including the ILECs'

revenues from other services expressly under the FCC's jurisdiction.[13]

Based on the evidence before it, the FCC concluded that TELRIC "should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings. We believe that a forward-looking economic cost methodology enables incumbent LECs to recover a fair return on their investment, *i.e.*, just and reasonable rates." JA 421-422 (¶ 738). Even so, the FCC ordered that ILECs "may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." JA 422 (¶ 739).

The ILECs' reliance on *Brooks-Scanlon* is thus misplaced. In *Brooks-Scanlon*, this Court held that the regulatory agency could not look to the profits earned by a railway company in a separate, unregulated lumber business to subsidize losses being incurred by the company in a regulated, unprofitable rail line. 251 U.S. at 399. As shown, the FCC based its analysis on the markets it regulates, not on any unregulated businesses of the ILECs. *Brooks-Scanlon* was also decided before this Court adopted the "total effect" test. Subsequent decisions have held that *Brooks-Scanlon* in no way precludes an agency from considering revenues from all parts of an entity's regulated business when applying the test. *See, e.g.*, *Baltimore & Ohio R.R. v. United States*, 345 U.S. 146, 150 (1953); *In re Valuation Proceedings Under §§ 303(c) & 306*

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[13] The above-cited record also shows that the FCC properly looked to this Court's precedents on just compensation, and did not attempt to interpret on its own "what costs the Constitution requires" to be recovered—as the ILECs wrongly suggest. Pet'r Br. at 25-26. The Court should reject the ILECs' attempt to parlay this fictitious argument into another ground for negating *Chevron* deference to the FCC's interpretation of "cost" in Section 252(d)(1).

of the Reg'l Rail Reorg. Act, 439 F. Supp. 1351, 1357 n.12 (Regional Rail Reorg. Ct. 1977).

Rather than coming forward with any specific information to prove a confiscatory rate, the ILECs have attempted instead to rewrite this Court's regulatory takings jurisprudence. In so doing, the ILECs have turned *Duquesne* on its head. As shown, *Duquesne* holds that there is no single rate methodology mandated by the Constitution and that it is constitutionally permissible for a ratemaker to change methodologies, even where doing so excludes historical costs prudently invested. The ILECs argue just the opposite here, stating that:

> [t]he FCC thus failed to conduct the inquiry *demanded* by *Duquesne*—whether TELRIC rates for UNEs will preserve incumbents' opportunity to recover their past prudent investment.

Pet'r Br. at 37 (emphasis added). This assertion demonstrates that it is the ILECs—not the FCC—that have misapplied *Duquesne*.

The ILECs' attempt to avoid the "total effect" test is not surprising, since "[o]nly the most egregiously confiscatory rate structure would have difficulty meeting" the "total effect" test reaffirmed there. Laurence H. Tribe, *American Constitutional Law* § 9-3 n.3 (2d ed. 1988). A utility thus bears a heavy burden in proving that rates are confiscatory under this standard. *In re Permian Basin*, 390 U.S. at 767. The ILECs failed to meet that burden before the FCC, JA 421-422 (¶ 738), and they have failed to meet it here. Although they broadly assert in their merits brief that state commissions "applying TELRIC ... typically produced discounts of 50% below historical cost," this "evidence" is based on the self-serving testimony of a single witness in an arbitration. The ILECs' claim that TELRIC leaves billions in network costs "stranded" is also belied by their own data, as shown *supra* pp. 33-34. These claims fail to demonstrate that

the "total effect" of the FCC's pricing rules is so unjust as to be confiscatory. The ILECs have not shown that they are unable to maintain their financial integrity or to attract necessary capital as a result of TELRIC or the Act's overall pricing scheme. *See Duquesne*, 488 U.S. at 312; *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987) (en banc).[14] Nor have they attempted to account for the substantial new sources of revenue that the Act now makes available to them by, among other things, allowing them access to the various long distance and other markets foreclosed by the AT&T consent decree. The ILECs' failure to come forward with any such evidence, five years after the Act was adopted, leaves no doubt that their "constitutional" challenge to TELRIC is not really based on takings principles, but rather on the policy choices properly made by the FCC.[15]

Finally, rejection of the ILECs' theoretical challenges to the TELRIC methodology will not foreclose judicial review of whether TELRIC-derived rates are themselves "confiscatory." Pet'r Br. at 40. *Duquesne* explicitly holds that a takings challenge must be based on the effect of a rate, not the methodology employed. The Act authorizes state commissions to conduct arbitrations to establish UNE rates and provides an avenue for judicial review of those

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[14] To the contrary, the ILECs' stock values have appreciated substantially since August 8, 1996, the date the FCC released its *Local Competition Order*. *See* Yahoo Finance Historical Quotes, *available at* http://chart.yahoo.com/d (providing split-adjusted historical stock data showing that from August 8, 1996 to June 1, 2001 stock prices for (i) BellSouth rose from $19.11 per share to $40.56 per share; (ii) SBC rose from $22.12 per share to $42.05 per share; and (iii) GTE/Verizon rose from $25.82 per share to $54.74 per share).

[15] The fact that the FCC has not concluded its Universal Service Order ("USO") proceedings does not save the ILECs' "takings" claim. The ILECs receive explicit universal service support, as well as compensation from the Act's other pricing provisions. JA 29-48.

determinations. JA 25-26. As much as the ILECs may prefer to challenge the constitutionality of the FCC's methodology in this proceeding, such a challenge can only proceed after the UNE rates that are a product of that methodology have been set and the effect of those rates can be tested.

C. The Doctrine Of Constitutional Avoidance Does Not Require The Inclusion Of Historical Costs In UNE Prices.

Having constructed their theoretical "takings" challenge to TELRIC, the ILECs next argue that the doctrine of "constitutional avoidance" negates *Chevron* deference and requires this Court to interpret Section 252(d)(1) in a way that avoids raising "serious constitutional questions." Pet'r Br. at 42. These questions can only be avoided, the ILECs contend, by interpreting the statute their way; *viz.*, to include historical costs. The Eighth Circuit correctly rejected this argument. *IUB II*, 219 F.3d at 754 (FCC Pet. App. 16a-18a). This Court should do the same.

The doctrine of constitutional avoidance is inapplicable in these circumstances because the Act provides a mechanism for the ILECs to receive compensation through state-arbitrated UNE rates. The Fifth Amendment does not proscribe the taking of property. "[I]t proscribes the taking of property without just compensation." *Williamson County Reg'l Planning Comm'n v. Hamilton Bank*, 473 U.S. 172, 194 (1985) ("*Williamson County*"). The Fifth Amendment requires only that an adequate mechanism for compensation exist. *Id.*

A narrowing construction of a statute to avoid a constitutional problem need only be invoked in those cases in which the application of a statute will necessarily constitute a taking and no means of compensation exists. Thus, in *Riverside Bayview Homes*, this Court did not invoke the doctrine of constitutional avoidance because (1) the regulation did not necessarily constitute a taking, and (2) even

if it did, a mechanism for compensation existed via the Tucker Act. The Court explained that, as long as compensation is available for those whose property is in fact taken, the government action is not unconstitutional. Because the availability of compensation negates any constitutional concerns, "adoption of a narrowing construction does not constitute an avoidance of a constitutional difficulty, it merely frustrates permissible applications of a statute or regulation." *Riverside Bayview Homes*, 474 U.S. at 128. As this Court explained,

> the possibility that the application of a regulatory program may in some instances result in the taking of individual pieces of property is no justification for the use of narrowing constructions to curtail the program if compensation will in any event be available in those cases where a taking has occurred.

Id.[16] *See also Railway Labor Executives' Ass'n v. United States*, 987 F.2d 806, 816 (D.C. Cir. 1993) ("Because just compensation is presumptively available under the Tucker

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[16] Contrary to the ILECs' assertion, it was appropriate for both the FCC and the Eighth Circuit to rely on *Riverside Bayview Homes* as support for the argument that a limiting construction of the Act is not warranted. The ILECs criticize the FCC and the Eighth Circuit for supposedly reading *Riverside Bayview Homes* to establish a general exemption from the principle of constitutional avoidance when the issue involves the Takings Clause. Pet'r Br. at 43-44. Neither the FCC nor the Eighth Circuit even suggested that *Riverside Bayview Homes* stands for that proposition. Rather, the case stands for the principle that the doctrine of constitutional avoidance should only be invoked when a taking necessarily occurs and there is no means available for compensation. When that principle is applied in this case, it is clear that a narrowing interpretation is not warranted. By contrast, in *Bell Atlantic Telephone Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994), a *pre*-Act case that, like *Riverside Bayview Homes*, involved the doctrine of constitutional avoidance, the D.C. Circuit applied a limiting construction to the Communications Act and vacated FCC regulations that required local exchange carriers to provide physical collocation because the Communications Act did not expressly authorize such a taking or provide a compensation mechanism for it. *Id.* at 1445.

Act, there is neither an unconstitutional result nor a constitutional doubt to be averted by interpretation.").

Just as the Tucker Act provided a means for compensation in the *Riverside Bayview Homes* and *Railway Labor* cases, and thereby removed the need for a limiting construction of the statutes at issue, the UNE compensation provisions of Section 252(d)(1) remove the need for any limiting construction of the statute to "avoid" a constitutional problem here. As the ILECs concede, the Act embodies the constitutional standard for just compensation. Their real argument is with the FCC's choice of TELRIC to provide it. The FCC was authorized to adopt a forward-looking cost model. That choice—even if deemed a "switch" in methodologies, as the ILECs contend—allows for adequate recovery by ILECs of their costs of providing UNEs to new entrants. TELRIC is thus consistent with the requirements of Section 252(d)(1) and the Takings Clause.

Moreover, as shown, an agency's choice between prudent-investment, historical cost, forward-looking cost, and replacement cost methodologies does not raise constitutional questions *per se*. Each method may provide just compensation when reasonably applied. Conversely, each method could result in unjust rates if misapplied. For these reasons, courts require financial data showing the actual effect of rates —not abstract methodological challenges—when evaluating a takings claim. The ILECs' takings claim is based solely on the choice of methodology made by the FCC and not on any credible evidence that TELRIC-derived rates are confiscatory.

The FCC has also ordered the ILECs to seek relief from the agency should they have credible evidence that TELRIC, "as applied to them, will result in confiscatory rates." JA 422 (¶ 739). The ILECs have yet to avail themselves of that remedy, which itself forecloses a takings challenge at this time. *See Williamson County*, 473 U.S. at 194-96.

Finally, TELRIC is not a "novel" methodology that tests "the outer limits of Congress' power," as the ILECs attempt to suggest. Pet'r Br. at 43. Forward-looking cost methodologies like TELRIC have been widely accepted in the professional literature, were implemented by several state utility commissions prior to passage of the Act, *see* JA 334-336 (¶ 631 & nn.1508-14), and have already passed constitutional muster, *see GTE*, 183 F.3d at 411-13 & nn.12-13.

Under these circumstances, adoption of a narrowing construction of Section 252(d)(1) would not "avoid" any serious constitutional question. It would instead frustrate the FCC's lawful interpretation of the provision to implement the Act's pro-competitive objectives. As the Eighth Circuit correctly found, there is no "need to disregard *Chevron* deference and interpret the statute in accordance with the [ILECs'] views in order to avoid an unconstitutional taking in this instance." *IUB II*, 219 F.3d at 754.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court affirm the FCC's UNE pricing rules in all respects.

Respectfully submitted,

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